No. 79-750

In the Supreme Court of the United States

OCTOBER TERM, 1979

LIBERTY NATIONAL LIFE INSURANCE COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner seeks review of the decision below in this federal income tax case holding that it was not entitled to treat any portion of the rate reductions it granted with respect to premiums on industrial life insurance policies paid on an annual or semi-annual basis as "discounts in the nature of interest" on advance premiums under Section 805(e)(3) of the Internal Revenue Code of 1954 (26 U.S.C.).

The pertinent facts are undisputed and may be summarized as follows: Petitioner is a life insurance company organized under Alabama law. A substantial portion of its business consists of the issuance of industrial life insurance policies (R. 820, 825).[1] Such

[1] "R." refers the record appendix filed in the court of appeals.

policies differ from conventional policies in that they are generally issued in small face amounts (under $100) and the premiums are collected personally, on a weekly basis, by the company's agents at the policyholder's home or place of employment. See generally McGill, *Life Insurance* 711-716 (rev. 1967). Following a practice that had been initiated in the 1930's by one of its predecessors (Brown-Service Insurance Company), petitioner allowed its industrial life policyholders a flat discount of five percent of the amount otherwise payable where premiums were paid in a single sum for a period of 26 weeks in advance, and ten percent of the amount otherwise payable where paid in a single sum for a full year in advance. (Pet. App. A A-2 to A-3).

On its federal income tax returns for 1966 through 1969, petitioner treated the aggregate amounts of these "discounts" not only as offsets against gross premium income in the computation of its "gain from operations" under Section 809 of the Code,[2] but also as "discounts in the nature of interest" on advance premiums to be offset against investment income in the computation of its "taxable investment income" pursuant to Section 805(e)(3) of the Code (R. 825). On audit, the Commissioner of the Internal Revenue disallowed the latter treatment claimed by petitioner. In this refund suit brought by petitioner in the United States District Court for the Northern District of Alabama, the district held that petitioner was entitled to treat these discounts as

[2]In the first two of the years at issue, petitioner simply reported its industrial life premiums net of the discount allowed. For 1968 and 1969, it reported the full amount of the premiums that would have been payable if paid on a weekly basis, claiming a separately stated offset for the discount allowed (R. 97-100).

"discounts in the nature of interest" on advance premiums under Section 805(e)(3). (Pet. App. A, A-4 to A-11).

The court of appeals reversed. It noted that the effective rates of interest reflected by these discounts were far in excess of both the interest rate petitioner paid or credited on conventional advance premium arrangements as well as the return it enjoyed on its own investments (Pet. App. B, A-41 to A-44), that petitioner's overall treatment of the transactions was inconsistent with the theory that these discounts were "in the nature of interest" (Pet. App. B, A-44 to A-46), and that the testimony of petitioner's own witnesses established "beyond doubt" that the discount was granted for "reasons entirely apart from the desire to obtain the early use of its policyholders' money" (Pet. App. A, A-47). The court of appeals therefore concluded that the district court's holding that the discounts were intended as payment for the use of money was "clearly erroneous" (Pet. App. B, A-48). While the court went on to suggest that it "could be argued" that a portion of the discount might yet be treated as being in the nature of interest and within the scope of Section 805(e)(3), it concluded that because petitioner had taken an all-or-nothing approach and "failed to convince us of the validity of its only argument, we must sustain the [Internal Revenue] Service's determination" (Pet. App. B, A-48).

1. The decision of the court of appeals is correct and in accord with the only other decision on point – *Liberty Life Insurance Co.* v. *United States*, 594 F. 2d 21 (4th Cir. 1979), cert. denied, No. 78-1825 (Oct. 1, 1979).[3] As

[3]The decision in *Liberty Life* was based on the dual grounds (1) that discounts allowed where mortgage cancellation insurance premiums otherwise payable on a monthly basis were paid for a full

the court of appeals noted, not all "discounts" are in the nature of interest, and only those which are actually granted as payment for the early use of the policyholders' money come within Section 805(e)(3). Recognizing that the question as to the nature of the discounts involved here was ultimately one of fact, the court below nevertheless concluded that the district court's decision was "clearly erroneous."

The court of appeals premised its holding on three factors. First, it noted that the effective rates of interest into which the flat discounts might be translated as much as 24 percent per annum—far exceeded both the four and one-half percent rate petitioner paid its policyholders for the use of their money in more conventional types of advance premium arrangements and also the six percent rate of return it enjoyed on its own investments. Noting that the very existence of a life insurance company depends on its "keen financial planning and investment," the court stated that it "strains our credulity" that petitioner would be willing to pay more for the early use of funds than it would expect to earn through use of such funds (Pet. App. B, A-42).

Second, the court noted that petitioner's own treatment of the discount arrangement was inconsistent with its assertion that the discounts were in the nature of interest. In this respect the court pointed to the manner in which petitioner's premiums income from these

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year in advance, were not "in the nature of interest" and (2) that the reduce payments could not be considered to be "premiums * * * paid in advance" under this statute (594 F. 2d at 27-29). The court of appeals in this case below ruled in favor of the government on the first ground. It therefore did not find it necessary to consider whether the annual and semi-annual payments here were advance premiums under Section 805(e)(3).

policies was computed and also petitioner's failure to file informational returns in the approximately 3,000 instances in which this would have been required if the discount had actually represented interest on advance premiums (Pet. App. B, A-45). Finally, the court cited the testimony of petitioner's own witnesses that the Brown-Service discount practice was continued after its merger with that company's former agents and policyholders and to improve the company's competitive position with respect to customers, such as farmers, who receive income only at certain times of the year. In its view, such evidence indicated that petitioner followed the discount practice not to obtain the early use of the policyholders' money, but simply as a convenience to petitioner and its policyholders (Pet. App. B, A-47).[4]

Petitioner argues (Pet. 13-16) that the court of appeals departed from accepted judicial practices in holding that the district court's decision was "clearly erroneous". But in so contending petitioner relies solely on the court of appeals' appraisal of the testimony and wholly ignores the first two factors, which the court concluded provided an independent basis for reversal (Pet. App. B, A-46).

Petitioner further urges that, whatever other reasons the record may show as to why it continued the Brown-Service discount policy, the assertions of its officers and

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[4]The district court had based its conclusion that the discounts were in the nature of interest largely on the evidence showing that Brown-Service had originally initiated this practice at a time when it was desperately in need of cash (Pet. App. A, A-5). As the court of appeals concluded, however (Pet. App. B, A-43), the fact that the discount "originated as interest does not mean that it must retain that character in perpetuity." It further noted that there was no evidence showing that the petitioner itself was in any such unusual need of funds at any time after it merged with Brown-Service in 1944 throughout the years in question (*ibid.*).

employees that it was allowing these discounts in order to enjoy the early use of the policyholders' money should govern the disposition of this case. But the objective evidence shows that the effective rate of the discount was as much as four times the return the company could then expect to earn through the use of such funds.[5] See *United States* v. *Generes*, 405 U.S. 93, 106-107 (1972). As this Court observed in *United States* v. *United States Gypsum Co.*, 333 U.S. 364, 395 (1948), the ultimate test for whether a finding is "clearly erroneous" is whether, despite the existence of some evidence to support the finding, the reviewing court is "left with the definite and firm conviction that a mistake has been committed." Here, the objective facts provided an ample basis for the court of appeals' "definite and firm" conviction that the discount was not designed simply to obtain the early use of the policyholder's money, notwithstanding the assertions of petitioner's witnesses to the contrary.[6]

2. Contrary to petitioner's further assertions (Pet. 2, 7, 16), the court of appeals properly declined to remand the case to the district court for the purpose of determining

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[5]Indeed, the effective rates here were far greater than those involved in *Liberty Life Insurance Co.* v. *United States*, *supra*, where the Fourth Circuit concluded that discounts reflecting effective rates of interest of between 7 and 14 percent per year could not reasonably be considered as in the nature of interest because they were far in excess of the interest rates actually paid on conventional advance premium arrangements and the rate of return enjoyed by that company on its investments (594 F. 2d at 28, 29).

[6]Petitioner also relies (Pet. 14-15) on the testimony of its expert actuarial witness that the discounts must have been in the nature of interest because payment of the industrial life premiums on an annual or semi-annual basis did not result in either an expense saving or a mortality saving. That witness's analysis, however, disregards the possibility that a rate adjustment may be based simply on competitive factors.

whether a part of the discounts in question could nevertheless be treated as "discounts in the nature of interest" on advance premiums under Section 805(e)(3) of the Code. In the first place, the court of appeals did not hold that petitioner was entitled to a portion of the refund claimed on the theory that the discounts could properly be treated as partially in the nature of interest. On the contrary, it merely suggested (Pet. App. B, A-48) that some part of the discount might be attributable to an interest element, and that it "*could be argued*" (emphasis added) that a portion of the discount could properly be deducted on this basis. At the same time, it noted that such an argument would itself be contrary to the decision in *Liberty Life*, *supra*.[7] It concluded, however, that it did not have to reach this question because petitioner, never argued that the discounts could, or should, be treated as partially "in the nature of interest" and, indeed, had specifically abjured such a position at oral argument (*ibid.*). Since petitioner had never previously sought a partial refund, even on an alternative basis, and had presented no basis at trial for apprortioning the discounts in question between deductibel "interest" and nondeductible elements, the court of appeals correctly declined to rule on whether the discounts could properly be treated as partially "in the nature of interest" under Section 805(e)(3) or to grant a

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[7]In this regard, the court of appeals noted (Pet. App. B, A-48), as had the district court (Pet. App. A, A-5), that the government had conceded at trial that there may be an "interest element" in the discount. But just as petitioner had taken an all-or-nothing position, the government had similarly argued that the discounts on advance premium payments were either "in the nature of interest" and entirely deductible under Section 805(e)(3), or were not deductible at all.

remand for the further factual findings that would have been necessary to allow a partial recovery on this basis.[8]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

JANUARY 1980

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[8]Indeed, before reaching this question, the court would first have been required to consider the alternative grounds advanced by the government and accepted in *Liberty Life* that the semi-annual or annual premium payments did not represent premiums paid in advance, but simply alternative modes of payment. See pages 3-4, note 3, *supra*. Moreover, before granting a remand for allowance of a partial refund on this basis, the court would have been required to rule on the three additional issues presented below involving offsets claimed by the government against any refund that petitioner might otherwise be entitled to recover (Pet. App. B, A-48).